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In the Supreme Court of the United States

OCTOBER TERM, 1937

No. —

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ELBE OIL LAND DEVELOPMENT COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Ninth Circuit, entered in the above cause on June 21, 1937, reversing a decision of the Board of Tax Appeals.

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 69–76) is reported in 34 B. T. A. 333. The opinion of the Circuit Court of Appeals has not yet been officially reported.

16808—37

JURISDICTION

The judgment of the Circuit Court of Appeals was entered June 21, 1937. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

In 1927 the taxpayer sold, assigned, transferred and conveyed all its right, title and interest in and to certain oil and gas leases, drilling equipment, etc., in consideration of a cash payment of $350,000 and thereafter, if the purchaser did not elect to abandon the purchase, the sum of $400,000 on the 14th day of March of each of the years 1928, 1929 and 1930, and $450,000 on March 14, 1931, or a total of $2,000,000. The agreement provided that from and after the time when the purchaser shall have been reimbursed, from the sale of oil and gas from the properties, for all expenditures made in the acquisition, development and operation of the properties, the purchaser should pay to the taxpayer 33⅓ per cent of its net profits, as therein defined, from the operation of the properties.

The question is whether, under Section 114 (b) of the Revenue Act of 1928, the taxpayer is entitled to a depletion deduction of 27½ per cent of the cash instalment payments received in each of the years 1928 and 1929.

STATUTE INVOLVED

The Revenue Act of 1928, c. 852, 45 Stat. 791, provides in part as follows:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (l) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. * * *
>
> * * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for depletion.*—

* * * * *

(3) *Percentage Depletion For Oil And Gas Wells.*—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

STATEMENT

As of October 3, 1927, under the terms of a written agreement (R. 37–64), the taxpayer sold, assigned, transferred and conveyed all its right, title and interest in and to certain described prospecting permits, drilling agreements, leases, and equipment unto the Honolulu Consolidated Oil Company (hereinafter referred to as Honolulu), the latter to "have the sole ownership of and the right to sell or otherwise dispose of, all oil and/or gas and derivative products produced in, on or upon said properties", it being "the intention of the parties to this agreement that the full and complete ownership, control and operation of said properties shall vest, upon execution hereof, in Honolulu * * *

and Elbe [the taxpayer] shall have no interest in or to any of said properties whatsoever." (R. 44–45.) The consideration to be paid the taxpayer, as set forth in paragraph 7 of the agreement, was $350,000 cash upon execution of the agreement, and thereafter, if Honolulu did not elect to abandon the purchase of the properties and execute reconveyances as provided by paragraph 9 of the contract, the sum of $400,000 on the 14th day of March of each of the years 1928, 1929 and 1930, and $450,000 on March 14, 1931, together with interest as specified. (R. 34, 47–48, 71.) Of such $2,000,000 to be received by the taxpayer, the amount of $1,963,672.95 was consideration for the oil and gas rights in the leases and the remainder was consideration for equipment and other property conveyed. (R. 35, 71.) The consideration of $2,000,000 for such sale was to be paid without reference to, and without being in any manner based upon, the production of oil from the properties conveyed. (R. 71.)

The contract, in paragraph 8 thereof (R. 48–54), provided that, "from and after the time" when Honolulu should have been reimbursed, from its sales of oil and gas from the properties, for all expenditures made in the acquisition, development and operation thereof, it should pay to the taxpayer 33⅓ per cent of its net profits, as defined in the contract, resulting from the production and operation of the properties (R. 48, 72). Up to the date of the hearing before the Board, no payments

became due or were made to the taxpayer by Honolulu under the terms of paragraph 8. (R. 35, 72.)

The agreement, in paragraph 12 thereof, provided that, anything contained in the agreement to the contrary notwithstanding, it was the intention of the parties that the full ownership, possession and control of all the properties should vest in Honolulu. (R. 61.)

The taxpayer has received each of the payments, in the amounts and on the dates specified in the agreement, totaling $2,000,000. The cost of all the properties transferred under the agreement was less than the amount of $350,000 received in 1927, and for that year the taxpayer reported a taxable gain from the transaction by applying the entire cost basis against the payment received in that year. (R. 71.)

In filing its income tax returns for the years 1928 and 1929, the taxpayer reported as income the $400,000 payment received in each of those years, and claimed as a deduction 27½ per cent thereof as an allowance for depletion. (R. 35–36, 71–72.) The Commissioner of Internal Revenue determined that the taxpayer was not entitled to any deduction for depletion (R. 36), and his action was affirmed by the Board of Tax Appeals (R. 69–77). Upon appeal, the Circuit Court of Appeals reversed, holding that percentage depletion was allowable on the payments received in 1928 and 1929.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the taxpayer was entitled to a 27½ per cent depletion allowance on the cash payments it received in each of the years 1928 and 1929.

2. In holding that the taxpayer retained such an interest in the oil and gas in place as entitled it to depletion allowances on the cash payments received in each of the years 1928 and 1929.

3. In holding that the taxpayer is entitled to depletion allowances for the years involved.

4. In reversing the Board of Tax Appeals.

REASONS FOR GRANTING THE WRIT

1. The decision of the Circuit Court of Appeals, holding that the taxpayer is entitled to deduct percentage depletion on the cash payments received in 1928 and 1929, is in direct conflict with the decision of the Circuit Court of Appeals for the Fifth Circuit in *Commissioner* v. *Fleming,* 82 F. (2d) 324. There, the taxpayer was the owner of an undivided interest in two oil and gas leases on which the landowner had reserved a one-eighth royalty. In 1928, by written instrument the taxpayer and the other owners of one of the leases sold it for $1,000,000 in cash, and $1,000,000 out of one-fourth of all oil, gas and other minerals produced. In 1929, he sold his interest in a similar gas and oil lease, together with certain equipment, part of the price to be paid by check, and the further sum of $225,000

to be paid out of the one-half of seven-eighths of the first oil produced and saved. Large amounts were received by the taxpayer in each year, both out of the cash payments and from oil produced. He contended that he was entitled to a depletion deduction on both the cash payment and the payment resulting from the production of oil. The court held, however, that the cash payment, which was not dependent upon the production of oil, was not subject to a depletion allowance. In so holding, the court said in part (pp. 327, 328):

> The making of the sale depleted nothing. The money paid did not come actually or in anyone's contemplation from the production of oil, but was the purchaser's independent capital invested by him in the oil lease. * * * We believe that the Board has correctly held that in such sales of interests in oil leases a money payment unconnected with production of oil is to be dealt with as representing a conversion of capital by sale, but that "oil payments" where no personal obligation is assumed by the purchaser are to have the benefit of the statutory depletion allowance.

So it is in this case. The making of the sale depleted nothing. The cash payments aggregating $2,000,000 were to be made without reference to, and without being in any manner based upon, the production of oil from the properties. It is true that until March 14, 1929, Honolulu had a right to abandon the purchase of the properties, but this

election did not depend upon whether oil and gas were being produced. The election was within the sole discretion of Honolulu, and might turn on any of the factors which influence a purchaser, e. g., the fluctuations in the selling price of oil, etc.

2. The Circuit Court of Appeals improperly extended and misapplied the decision in *Palmer* v. *Bender,* 287 U. S. 551, by holding that the taxpayer had at all times an economic interest in the oil produced (from which premise it concluded that depletion allowances on the cash payments were proper). In the *Palmer* case, this Court held that the language of the statute was broad enough to allow a deduction for depletion in every case in which the taxpayer had retained an economic interest in the oil and gas in place.

Here, the taxpayer did not retain an economic interest in the oil and gas in place, but only the right, after certain contingencies had happened, to share in the *net profits* accruing to Honolulu from the operation of the properties. It retained neither the right to share in the oil produced and saved, as in *Palmer* v. *Bender, supra,* nor the right to receive royalties, in cash or in kind, equal to a specified proportion of the oil extracted, as in *Helvering* v. *Twin Bell Syndicate,* 293 U. S. 312, 315, 321, nor a right to receive a specified amount out of the gross proceeds of the oil, as in *Thomas* v. *Perkins,* decided June 1, 1937, No. 824, October Term, 1936. Its only interest was a right under the agreement to

receive a specified portion of Honolulu's net profits, if any, from operation of the leases. Such an interest cannot be said to constitute that *ownership,* either of the oil produced or of its precise equivalent, the gross proceeds of the oil, which under the statute is essential.

In *Thomas* v. *Perkins, supra,* this Court, in discussing the *Palmer* case, said:

> Thus in that case we held assignors' mere stipulation for royalty out of oil operated to save to them an economic interest in the *oil* sufficient to entitle them to deduct from their income derived from the oil an allowance for depletion. If Palmer had retained no interest in the oil he would have been entitled to no deduction on account of depletion. *Ownership was essential.* [Italics supplied.]

It follows that the taxpayer, having disposed of its interest in the oil in place, is not entitled to depletion allowances.

This question is also presented in *Helvering* v. *O'Donnell,* pending on the Commissioner's petition, No. 406, present term.

3. Petition for certiorari has heretofore been filed by the Commissioner in *Helvering* v. *Bankline Oil Co.,* No. 387, present term, involving a closely related question. Apart, however, from the pendency of the petitions in the *O'Donnell* and *Bankline* cases, it is submitted that certiorari should be

granted here in order to resolve the conflict with the decision of the Circuit Court of Appeals for the Fifth Circuit in *Commissioner* v. *Fleming*, p. 7, *supra*.

CONCLUSION

Wherefore, it is respectfully submitted that this petition should be granted.

STANLEY REED,
Solicitor General.

SEPTEMBER 1937.

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